87 - 1148

No.

Supreme Court, U.S.
FILED
JAN 5 1988
JOSEPH F. SPANIOL, JR.
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

ILLINOIS DEPARTMENT OF REVENUE and ROGER SWEET, Director of Illinois Department of Revenue,

Petitioners,

v.

STEPHEN J. ANDRAS and BETTY I. ANDRAS and TRUST FOR SHORT-TERM U.S. GOVERNMENT SECURITIES,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE ILLINOIS APPELLATE COURT, SECOND JUDICIAL DISTRICT

NEIL F. HARTIGAN
Attorney General, State of Illinois
SHAWN W. DENNEY
Solicitor General, State of Illinois
100 West Randolph Street, 12th Floor
Chicago, Illinois 60601
(312) 917-3312

Attorneys for Petitioners

ROSALYN B. KAPLAN *
BRET A. RAPPAPORT
Assistant Attorneys General
100 West Randolph Street, 12th Floor
Chicago, Illinois 60601
(312) 917-3698

Of Counsel

* Counsel of Record

BEST AVAILABLE COPY

QUESTION PRESENTED

Is a state prohibited by the constitutional doctrine of inter-governmental tax immunity from including in taxable income, for state income tax purposes, dividends paid by a regulated investment company (mutual fund) to its individual investors where the mutual fund invests primarily in federal government securities and regularly pays out its entire net income to its investors?

LIST OF PARTIES

The original parties in the Illinois Circuit Court were the plaintiffs, Stephen Andras and Betty Andras ("Taxpayers") and the Trust for Short-Term U.S. Government Securities ("Fund"), and the defendants, the Illinois Department of Revenue and its Director at the time, J. Thomas Johnson, sued as Timothy Johnson. Roger Sweet is now the Director of the Illinois Department of Revenue and has been substituted in this action pursuant to Supreme Court Rule 40.3.

TABLE OF CONTENTS

	PAGE
QUESTION PRESENTED	i
LIST OF PARTIES	ii
TABLE OF AUTHORITIES	iv
OPINION BELOW	2
JURISDICTION	2
STATUTES INVOLVED	2
STATEMENT OF THE CASE	3
REASONS FOR GRANTING THE WRIT:	
IN FAILING TO RECOGNIZE THAT INTEREST EARNED ON FEDERAL OBLIGATIONS OWNED BY THE FUND DOES NOT RETAIN ITS TAX-EXEMPT CHARACTER WHEN PAID OUT TO THE INVESTORS IN THE FUND, THE ILLINOIS TRIBUNAL ERRONEOUSLY DEPRIVED THE STATE OF THE ABILITY TO TAX THAT INCOME OF THE INVESTOR	6
CONCLUSION	13

APPENDIX

Opinion of the Appellate Court of Illinois	App. 1
Order of the Illinois Supreme Court denying the petitioners' petition for leave to appeal	App. 11
Order of the Circuit Court of Kane County	App. 12
Administrative decision of the Illinois Department of Revenue	App. 13

TABLE OF AUTHORITIES

Cases	PAGE
American Bank & Trust Co. v. Dallas County, 463 U.S. 855 (1983)	*passim*
Andras v. Department of Revenue, 154 Ill. App. 3d 37, 506 N.E.2d 439, 106 Ill. Dec. 732 (2d Dist. 1987)	2
Cleveland Trust Co. v. Lander, 184 U.S. 111 (1902)	8
Des Moines National Bank v. Fairweather, 263 U.S. 103 (1923)	8
Dovey v. United States, 254 F.2d 538 (3rd Cir. 1958)	9
First National Bank of Atlanta v. Bartow County Board of Tax Assessors, 470 U.S. 583 (1985)	7, 10
McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819)	7
Memphis Bank & Trust Co. v. Garner, 459 U.S. 392 (1983)	7
Miller v. City of Milwaukee, 272 U.S. 713 (1927)	8
Putnam's Estate v. Commissioner of Internal Revenue, 324 U.S. 393 (1945)	8
Rockford Life Insurance Co. v. Illinois Department of Revenue, ___ U.S. ___, 107 S. Ct. 2312 (1987)	7
Society for Savings in City of Cleveland, Ohio v. Bowers, 349 U.S. 143 (1955)	8
United California Bank v. United States, 439 U.S. 180 (1978)	9

Weston v. City of Charleston, 27 U.S. (2 Pet.) 449 (1829) 7

Woodruff v. Tax Commission, 440 A.2d 854 (Conn. 1981) 9

Constitutional Provisions

U.S. Const. Art. I, § 8. cl. 2, Art. VI, cl. 2 ... 7

Statutes

26 U.S.C. §§ 701, 702(b) 9

26 U.S.C. §§ 851-55 ..... 4, 9

28 U.S.C. § 1257(3) 2

31 U.S.C. § 3124 (1985) 2, 3, 7, 11

Ill. Rev. Stat. ch. 120, ¶ 2-203(a)(2) (1985) 3

Administrative Provisions

26 C.F.R. § 1.312-6(b) (1987) 8

Other Authorities

4 U.S. Code Cong. & Ad. News (1976), pp. 2897, 4240 9

Lipper-Fixed Income Fund Performance Analysis, Oct. 31, 1987, (Lipper Analytical Services, Inc., N.Y., N.Y.) 6

7 Mertens, *Laws of Federal Income Taxation*, §§ 38.04 and 38.05 (rev. ed. 1976) 8

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

ILLINOIS DEPARTMENT OF REVENUE and ROGER SWEET, Director of Illinois Department of Revenue,

Petitioners,

v.

STEPHEN J. ANDRAS and BETTY I. ANDRAS and TRUST FOR SHORT-TERM U.S. GOVERNMENT SECURITIES,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE ILLINOIS APPELLATE COURT, SECOND JUDICIAL DISTRICT

Petitioners, the Illinois Department of Revenue and its Director, Roger Sweet, respectfully pray that a writ of certiorari issue to review the judgment and opinion of the Illinois Appellate Court for the Second Judicial District entered in the above-entitled cause on March 31, 1987. The Illinois Supreme Court denied petitioners' petition for leave to appeal on October 7, 1987.

OPINION BELOW

The opinion of the Appellate Court is reported at 154 Ill. App. 3d 37, 506 N.E.2d 439, 106 Ill. Dec. 732 (2d Dist. 1987). The opinion is attached as an Appendix hereto (App. 1-10). Also attached are the order of the Illinois Supreme Court denying the petitioners' petition for leave to appeal on October 7, 1987 (App. 11), the order of the Circuit Court of Kane County (App. 12), and the administrative decision of the Illinois Department of Revenue (App. 13-24).

JURISDICTION

The opinion of the Illinois Appellate Court was issued on March 31, 1987. Leave to appeal was denied by the Illinois Supreme Court on October 7, 1987. Jurisdiction in this Court is vested by 28 U.S.C. § 1257(3).

STATUTES INVOLVED

31 U.S.C. § 3124:

> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except—

(1) a nondiscriminatory franchise tax or another non-property tax instead of a franchise tax, imposed on a corporation; and

(2) an estate or inheritance tax.

Ill. Rev. Stat. ch. 120, ¶ 2-203(a)(2) (1985):

The adjusted gross income [of a taxpayer] . . . shall be modified . . . by deducting . . . (O) an amount equal to all amounts included in such total which are exempt from taxation by this State either by reason of its Constitution or by reason of the Constitution, treaties or statutes of the United States . . . .

STATEMENT OF THE CASE

For the tax year ending December 31, 1980, Stephen J. and Betty I. Andras ("investors" or "taxpayers"), who are Illinois residents, timely filed an Illinois income tax return. The return indicated a subtraction modification on Line 4 ("Interest on U.S. Obligations included on Line 1") in the amount of $13,552.00. The Line 4 modification represented income paid by the Trust for Short-Term U.S. Government Securities (the "Fund") to the Andrases during 1980.

The Fund is a no-load, open-end, diversified investment company established as a Massachusetts Business Trust under a Declaration of Trust dated October 30, 1975. An individual invests in the Fund by purchasing shares at net asset value. One share equals one dollar. The shares are purchased through Federated Securities Corporation, the Fund's distributor. The minimum investment in the Fund is $100,000. In 1980, the tax year in question in this

case, the Fund had total assets of almost three billion dollars.

The investor receives a return on his investment in the form of dividends. Substantially all of the Fund's accumulated net income is declared as dividends daily. The balance of the net income is used to pay the Fund's expenses. Payment of the dividends is made monthly and is paid to the investor either in cash or in additional shares, at the investor's option. The investor can cancel his investment by redemption of the shares he purchased along with any accumulated unpaid dividends.

The Fund operates as a regulated investment company (commonly known as a mutual fund) under the Internal Revenue Code ("IRC"), 26 U.S.C. §§ 851-55, and, accordingly, is exempt from federal corporate income taxation. The Fund seeks to provide investors with high current income consistent with stability of principal and liquidity. It pursues this objective by investing heavily in short-term U.S. government securities. Specifically, the Fund invests in three types of securities: (1) direct federal credit obligations; (2) securities issued by or guaranteed by federal agencies; and (3) repurchase agreements.[1]

In this case, the Illinois Department of Revenue ("Department") issued a notice of change reducing to zero the taxpayers' Line 4 subtraction amount for interest earned on U.S. securities. The Andrases filed an amended return claiming a refund, and paid the additional amount due.

---

[1] Repurchase agreements are contracts entered into between the Fund and a bank or other recognized financial institution. These contracts provide for the purchase and simultaneous agreement to resell U.S. government securities for later delivery at an agreed-upon price and interest rate.

Their claim was denied and they filed a timely protest. An administrative hearing was held on November 10, 1983. On September 11, 1985 the Department issued its Notice of Decision denying the Andrases' claim for refund.

The Andrases sought judicial review of this decision in the Circuit Court of Kane County, Illinois. The circuit court upheld the Department's decision, and the taxpayers appealed. On March 31, 1987 the Illinois Appellate Court, Second Judicial District, issued a decision holding that the State of Illinois may not tax income earned by a taxpayer when it is paid to him as dividends from a mutual fund that invests primarily in U.S. government securities and pays out its entire net income to its investors. However, the state may tax the portion of the dividend income resulting from the mutual fund's return on investments that are not tax-exempt U.S. government securities.

The Department filed a timely petition for leave to appeal with the Illinois Supreme Court. On October 7, 1987 the Illinois Supreme Court issued an order denying the petition.

REASONS FOR GRANTING WRIT

IN FAILING TO RECOGNIZE THAT INTEREST EARNED ON FEDERAL OBLIGATIONS OWNED BY THE FUND DOES NOT RETAIN ITS TAX-EXEMPT CHARACTER WHEN PAID OUT TO THE INVESTORS IN THE FUND, THE ILLINOIS TRIBUNAL ERRONEOUSLY DEPRIVED THE STATE OF THE ABILITY TO TAX THAT INCOME OF THE INVESTOR.

Resolution of the issue presented will have a profound effect on the states and their taxpayers.[2] Essentially, this

[2] According to published market data, regulated investment companies, such as the Fund, that invest primarily in federal obligations, own approximately $113,115,700,000.00 in such securities. *Lipper-Fixed Income Fund Performance Analysis*, Oct. 31, 1987, pp. 7, 15 (Lipper Analytical Services, Inc., N.Y., N.Y.). Although the interest on particular obligations may vary, a flow-through tax-exempt character for all of the interest earned on the holdings of these regulated investment companies would deprive the states of the ability to tax a substantial source of individual income, amounting to hundreds of millions of dollars per year.

The issue which petitioners present for review is a federal constitutional and statutory question that has been litigated or is presently being litigated in state courts throughout the nation. *See e.g.* (California) *Sandra L. Brown, Capital Preservation Fund et al. v. Franchise Tax Board*, No. 803759, slip op. (Sup. Ct. Cal., San Fran. Co. Oct. 11, 1983), appeal pending No. A035598, Cal. App. 1st Dist.; (Indiana) *Estate of Haldon C. Kraft v. Indiana Department of Revenue*, No. C85-789 (Cir. Court, Hamilton Co. Dec. 2, 1986); (Iowa) *William A. Everett*, Iowa Dept. Rev. No. 84-215-26-RC (1987), appeal pending Iowa Dept. of Rev.; (Maryland) *Comptroller v. First United Bank & Trust as Guardian Dale W. Alexander*, No. 87218095/CL69604 (Cir. Ct. Baltimore City); (Michigan) *Matz v. Department of Treasury*, 155 Mich. App. 778, 401 N.W.2d 62 (1986); (Minnesota) *The Trust for Short-Term U.S. Government Securities v. Department of Revenue*, (Hennepin Co. Dist. Ct. 1987); (Oregon) *Borg v. Department of Revenue*, No. 2410 (Or. Tax Court 1986) and *Waterbury v. Department of Revenue*, No. 2653 (Or. Tax Ct. 1986); (Vermont) *In Re Sawyer's Estate*, No. 86-177 slip op.

(Footnote continued on following page)

Court is urged to decide which of two distinct theories must govern the determination of a state's ability to tax the income earned as a dividend paid by a mutual fund that invests primarily in U.S. government securities.[3]

The Department argues for adoption of the entity or non-conduit theory. According to this approach, the tax-exempt character of a dollar earned by the Fund retains that character only so long as that entity retains ownership, possession and control of that dollar. Once paid out, however, to the investor/taxpayer (or any other entity), that dollar sheds its tax-exempt character and becomes ordinary income earned by the investor/taxpayer.

The taxpayers and the Fund urge the adoption of the conduit or flow-through theory for the taxability of divi-

---

[2] *continued*
(Dec. 11, 1987, Vt. Supreme Court), *Keys v. Vermont Department of Taxes*, No. 85-531 slip op. (Dec. 24, 1987, Vt. Supreme Court); (Wisconsin) *Capital Preservation Fund, et al. v. Wisconsin Department of Revenue*, No. 86-CV-1385, slip op. (Cir. Ct. Dane Co. June 1, 1987), appeal pending No. 87-1303 Wisc. Court of Appeals District IV.

[3] At the heart of this controversy is the doctrine of inter-governmental tax immunity. 31 U.S.C. § 3124(a) embodies the prohibition on States from taxing obligations of the United States. The statute is a codification of the constitutional immunity of federal obligations from state and local taxation, and it does not broaden the scope mandated by the Constitution. *First National Bank of Atlanta v. Bartow County Board of Tax Assessors*, 470 U.S. 583 (1985); *Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392, 397 (1983). A narrow construction should be placed upon the doctrine of inter-governmental tax immunity. *Rockford Life Insurance Co. v. Illinois Department of Revenue*, ____ U.S. ____, 107 S.Ct. 2312, 2317-18 (1987).

The constitutional bases for the prohibition against state taxation of federal obligations are the Borrowing and Supremacy Clauses of the Constitution. U.S. Const. Art. I, § 8, cl. 2; Art. VI, cl. 2. *See McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819); *Weston v. City of Charleston*, 27 U.S. (2 Pet.) 449, 468 (1829).

dends paid to the taxpayers from the Fund. Under this theory, the tax-exempt character of a dollar earned by the Fund, which purchases and owns the U.S. government obligation, retains that tax-exempt character when paid to the taxpayer.

The principle of separation between entities and individuals owning interest in such entities is well established. *See Des Moines National Bank v. Fairweather*, 263 U.S. 103 (1923) (state tax on shareholder's distribution not equivalent to tax on property of corporation; therefore, shareholder not entitled to deduction based on bank's holdings in U.S. government obligations); *Society for Savings in City of Cleveland, Ohio v. Bowers*, 349 U.S. 149 (1955) (stockholder's interest in a corporation represents a separate property interest from the corporation's ownership of its assets, so a tax on the stockholder's interest is not a tax on federal obligations which are included in corporate property); *Putnam's Estate v. Commissioner of Internal Revenue*, 324 U.S. 393 (1945); *Miller v. City of Milwaukee*, 272 U.S. 713 (1927); *Cleveland Trust Co. v. Lander*, 184 U.S. 111 (1902). *See also* Treas. Reg., 26 C.F.R. § 1.312-6(b) (1987); 7 Mertens, *Laws of Federal Income Taxation*, §§ 38.04 and 38.05 (rev. ed. 1976). Accordingly, an exemption from state taxation is available only when the owner of the federal obligation receives the interest income from the government.

The entity concept (the separation between the taxable entity and the individuals owning interest in such entities, and the non-conductible character of the income from one to the other) operates with respect to income transfer unless pass-through treatment of a given type of income is specifically authorized. For example, section 662(b) of the IRC specifically authorizes pass-through treatment of

income earned by an estate or trust when paid out as distributions to the beneficiaries. 26 U.S.C. § 662(b); *United California Bank v. United States*, 439 U.S. 180, 192 n. 12 (1978); *Dovey v. United States*, 254 F.2d 538, 541 (3d Cir. 1958). Similarly, sections 701 and 702(b) of the IRC expressly permit the tax-exempt character of income earned by a partnership to pass through unchanged to the partners. 26 U.S.C. §§ 701, 702(b).

The Fund qualifies under the IRC as a regulated investment company and is treated as a separate legal entity. 26 U.S.C. § 852. Prior to the Tax Reform Act of 1976, distributions to shareholders from regulated investment companies were taxable in all circumstances, and only the character of capital gains and certain dividend income "flowed through" to shareholders. *See* 4 U.S. Code Cong. & Ad. News (1976), pp. 2897, 4240; *Woodruff v. Tax Commission*, 440 A.2d 854, 856 (Conn. 1981). The IRC was then amended to allow certain exempt interest earned by the regulated investment company to be passed through to the shareholders. Accordingly, 26 U.S.C. § 852(b)(5)(A) expressly provides that tax-exempt interest income from "obligations described in section 103(a)" of the IRC passes through the entity to the shareholders. Section 103 obligations are state and local obligations. 26 U.S.C. § 103.

Unlike the express statutory pass-through for income earned through ownership of state and local obligations, neither the IRC nor any other federal law expressly permits regulated investment companies to pass through to their shareholders the "federal obligation" character of money they earn on obligations which they own. According to a House and Senate Committee reports "[d]ividends paid by such companies are taxed in the usual manner to shareholders" except where the IRC provides

expressly for flow-through treatment. U.S. Code Cong. & Admin. News 4017, 4099; 4621, 4734.

In the instant case, the Illinois tribunal erred in failing to recognize the well established entity concept with respect to the flow of income and the character of that income when paid over from one entity to another. The appellate court relied on this Court's decision in *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855 (1983), and improperly interpreted that case as holding that "there are no implied exceptions to [inter-governmental tax immunity]—not even the historical distinction between a corporation and its shareholders." App. at 2.

In *American Bank & Trust*, this Court held that the statutory prohibition against inter-governmental taxation prevented a state from imposing a property tax on bank shares, when the tax was computed on the basis of the bank's net worth without a deduction for tax-exempt U.S. obligations owned by the bank. 463 U.S. at 855; *see First National Bank of Atlanta*, 470 U.S. 583. The state tax scheme in *American Bank & Trust* was not struck down because it was a property tax on the value of stock of an entity that owned federal obligations. Rather the tax was invalidated because the taxpayer's ownership interest in federal obligations was considered in computing the tax. 463 U.S. at 857.

In law and logic income taxes, such as those in the instant case, require a different analysis from that which is applied to property taxes, such as those at issue in *American Bank & Trust*. This is because income is different from property. Property is a stock of value owned by a single entity at a point in time. Accordingly, if a certain entity owns federal obligations, a state cannot tax those federal obligations indirectly by imposing a tax on

assets, capital stock or retained earnings of the entity rather than on the federal obligation itself. This is because property is a stock held by a *single entity* and a state may not indirectly tax the federal obligations owned by an entity. 31 U.S.C. § 3124(a). Such formalistic distinctions within a single entity will be disregarded. *American Bank & Trust.*

Income, unlike property, is not a stock of value held by a single entity. Rather, income is the flow of value, represented by dollars, from entity to entity over a period of time. The entity concept is a doctrine that applies to income. It recognizes that the character of a dollar is determined by the relationship between the transferor and transferee of that dollar at the time of the transfer. A given dollar does not always retain the character it had when A paid it over to B. Once that dollar is paid over from B to C its character is determined by the relationship between B and C. Thus a property tax is a tax on the value of the item itself, whereas an income tax is assessed against an entity for the privilege of earning income. Each separate entity has a distinct privilege when it earns a dollar and it is that privilege which is taxed.

Absent the distinctions between entities the proper assessment of income tax liability would be an impossible task. This point may be illustrated with reference to the appellate court's decision. The court held that the tax-exempt character of the income earned by the Fund remains intact because the owner-entity (the Fund) pays out its entire net income, earned through investments in U.S. government securities, to its investors. Under this reasoning, the investor could assign the dividend dollars to his creditor and the tax-exempt character would remain intact. The state thus could not tax the dollars of income earned by the creditor in that transaction.

Similarly, under this analysis, an individual who owns a business could purchase tax-exempt federal obligations and assign the entire amount of interest earned to his employees in place of the payment of wages from the firm. Since the income was tax-exempt to the firm, it would remain exempt when paid out to the employees. No state income tax liability could be imposed on the dollars earned by the employees.

This Court should grant certiorari in this case because of the importance of the issue presented. Supreme Court Rule 17.1(c). *See American Bank & Trust Co.*, 463 U.S. at 861. This issue of the pass-through treatment of federal obligation interest earned by a regulated investment company and paid out to the stockholders has never been addressed by this Court. The issue is of nationwide importance and the ultimate resolution of this issue involves hundreds of millions of dollars annually in revenue to the States. *See* n. 2, *supra*.

CONCLUSION

For these reasons, this petition for certiorari should be granted.

Respectfully submitted,

NEIL F. HARTIGAN
Attorney General, State of Illinois

SHAWN W. DENNEY
Solicitor General, State of Illinois

100 West Randolph Street, 12th Floor
Chicago, Illinois 60601
(312) 917-3312

Attorneys for Petitioners

ROSALYN B. KAPLAN *
BRET A. RAPPAPORT
Assistant Attorneys General
100 West Randolph Street, 12th Floor
Chicago, Illinois 60601
(312) 917-3698

Of Counsel

* Counsel of Record

APPENDIX

154 Ill.App.3d 37
106 Ill.Dec. 732

Stephen J. ANDRAS and Betty I. Andras and Trust for Short-Term U.S. Government Securities, Plaintiffs-Appellants,

v.

ILLINOIS DEPARTMENT OF REVENUE and Timothuy Johnson, Director of Illinois Department of Revenue, Defendants-Appellees.

No. 2-86-0535.

Appellate Court of Illinois,
Second District.

March 31, 1986.

* * *

Justice UNVERZAGT delivered the opinion of the court:

Plaintiffs, Stephen and Betty Andras [hereinafter referred to as the taxpayers], appeal from a judgment of the circuit court of Kane County which affirmed the decision of the Illinois Department of Revenue concluding that they could not deduct from their gross income for Illinois income tax purposes distributions received by them from the Trust for Short-Term U.S. Government Securities [the Trust]. The Trust is also a plaintiff in this appeal.

The facts are not disputed. The Trust was established as a Massachusetts Business Trust and operates as a Regulated Investment Company, as defined in section 851(a) of the Internal Revenue Code (26 U.S.C. sec. 851(a) (1982)), and commonly known as a mutual fund. Investors buy shares in the Trust through a distributor, and receive dividends on those shares on a monthly basis. With the exception of its expenses, the Trust pays out all of its net income to its shareholders in dividends. The Trust invests exclusively in short-term U.S. Government securities the interest on which is exempted from State taxation

by Federal law. (31 U.S.C., sec. 742 (1976)).[1] The Illinois Department of Revenue [hereinafter referred to as the Department] refused to apply the exemption to taxpayers' dividend income, however, finding that the Trust is taxable under Illinois law as a corporation, and is therefore a distinct taxable entity which cannot pass its exemptions through to its shareholders unless the pass-through is specifically authorized by statute. In addition, the Department found that certain repurchase agreements involving government securities were in fact loans by the Trust to the sellers and that the interest on them was therefore ordinary rather than tax-exempt income.

There are two issues presented for appeal: (1) whether section 742 of title 31 requires states to exempt from State income taxation dividend income paid to shareholders of mutual funds which pay out their entire net income in dividends on a regular basis, and (2) whether income from the Trust's repurchase agreements involving government securities is tax-exempt.

I.

Section 742 (31 U.S.C. sec. 742 (1976)) exempts U.S. Government securities and the interest received on them from State taxation. Plaintiffs argue that, in its decision in *American Bank & Trust Co. v. Dallas County* ((1983), 463 U.S. 855, 103 S.Ct. 3369, 77 L.Ed.2d 1072), the United States Supreme Court held that there are no implied exceptions to section 742—not even the historical distinction between a corporation and its shareholders on which the department relies.

---

[1] Title 31 was reformulated in 1982, and section 742 was replaced by section 3124(a) (31 U.S.C. sec. 3124(a) (1982)), without substantial change. (See *First National Bank v. Bartow County Board of Tax Assessors* (1985), 470 U.S. 583, 585 n. 1, 105 S.Ct. 1516, 1518 n. 1, 84 L.Ed.2d 535, 538 n. 1.) Prior section 742 technically controls this case, however, because the tax year involved is 1980.

We will review the history of section 742 and some earlier Supreme Court cases before discussing the *American Bank & Trust* decision. Two landmark decisions of the Supreme Court established that the constitution necessarily immunizes the Federal government (*McCulloch v. Maryland* (1819), 17 U.S. (4 Wheat.) 316, 4 L.Ed. 579), and obligations of the Federal government from State taxation. (*Weston v. City Council of Charleston* (1829), 27 U.S. (2 Pet.) 449, 7 L.Ed. 481.) Section 742 is the most recent in a succession of statutes which codified that constitutional rule. (See *First National Bank v. Bartow County Board of Tax Assessors* (1985), 470 U.S. 583, 592-93, 105 S.Ct. 1516, 1522, 84 L.Ed.2d 535, 543; *Memphis Bank & Trust Co. v. Garner* (1983), 459 U.S. 392, 397, 103 S.Ct. 692, 695, 74 L.Ed.2d 562, 567; *Society for Savings v. Bowers* (1955), 349 U.S. 143, 144, 75 S.Ct. 607, 608, 99 L.Ed. 950, 955.) The Illinois Supreme Court has acknowledged this as the purpose of section 742. *Rockford Life Insurance Co. v. Department of Revenue* (1986), 112 Ill.2d 174, 178-79, 97 Ill.Dec. 405, 492 N.E.2d 1278.

In 1866, the Supreme Court decided *Van Allen v. Assessors* ((1866), 70 U.S. (3 Wall.) 573, 18 L.Ed. 229) in which taxpayers challenged State taxes imposed on shareholders' interests in several national banks, claiming that the property should be immune from State taxation under the earliest predecessor of section 742. The court stated that a shareholder's interest in a corporation is a "distinct, independent interest or property * * *" not equivalent to the corporation's interest in its assets and concluded that, in any event, the National Bank Act affirmatively authorized states to tax shareholders of national banks. (70 U.S. 573, 584-86, 18 L.Ed 229, 234-35.) In *Cleveland Trust Co. v. Lander* ((1902), 184 U.S. 111, 22 S.Ct. 394, 46 L.Ed. 456), the same immunity argument was raised by taxpayers who, like the plaintiffs here, were shareholders in a trust company which had invested in U.S. Government securities. The court again rejected the argument, relying on *Van Allen*, and held that granting the shareholders immunity from State taxation would destroy the

distinction between the trust company and its shareholders (184 U.S. 111, 114-15, 22 S.Ct. 394, 395-96, 46 L.Ed. 456, 458), and that applying the immunity rule would put shareholders of a trust in a more advantageous position than shareholders of a national bank. (184 U.S. 111, 113, 22 S.Ct. 394, 395, 46 L.Ed. 456, 458.) The *Van Allen* rule was more recently applied in *Society for Savings v. Bowers* ((1955), 349 U.S. 143, 147, 75 S.Ct. 607, 610, 99 L.Ed. 950, 957, in which the court again concluded that a stockholder's interest was a property interest distinct from the corporation's assets.

Each of the above decisions, however, was decided prior to the 1959 amendment of section 742. Until 1959, the section provided: "[a]ll stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority." (31 U.S.C. sec. 742). It was amended in 1959 by the addition of the following language:

> "This exemption extends to every form of taxation that would require that either the obligations or the interest thereon, or both, be considered, directly or indirectly, in the computation of the tax, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes." 31 U.S.C. sec. 742 (1975).[2]

In *American Bank & Trust Co. v. Dallas County* ((1983), 463 U.S. 855, 103 S.Ct. 3369, 77 L.Ed.2d 1072), the Supreme Court considered the effect of the additional language on the distinction recognized since *Van Allen* between a State property tax imposed directly on a national bank and one imposed only on its shareholders' interests. The court noted that in addition to the change to the language of section 742, there is no longer any affirmative statutory authorization for a State to tax shareholders'

---

[2] The same language is contained in the reformulated statute now at 31 U.S.C. sec. 3124 (1982).

interests in a national bank. (463 U.S. 855, 868, 103 S.Ct. 3369, 3378, 77 L.Ed.2d 1072, 1082-83.) The court invalidated the tax, holding that the amendment "abolished the formalistic inquiry whether the tax is *on* a distinct interest and replaced it with the inquiry whether 'computation of the tax' requires consideration of federal obligations." (463 U.S. 855, 867, 103 S.Ct. 3369, 3377, 77 L.Ed.2d 1072, 1082.) The court stated that the new language indicated a congressional intent "to sweep away formal distinctions and to invalidate all taxes measured directly or indirectly by the value of federal obligations, except those specified in the amendment." (463 U.S. 855, 867, 103 S.Ct. 3369, 3377, 77 L.Ed.2d 1072, 1082.) In discussing *Van Allen*, *Cleveland Trust*, and *Society for Savings*, the court stated that the prior version of section 742 permitted taxing the shareholders because their interests were "separate from the federal obligations held by the bank." (463 U.S. 855, 871, 103 S.Ct. 3369, 3379, 77 L.Ed.2d 1072, 1084.) The court noted that the 1959 amendment "abolished the relevance of this formalistic theory." 463 U.S. 855, 872-73 n. 14, 103 S.Ct. 3369, 3379-80 n. 14, 77 L.Ed.2d 1072, 1085 n. 14.

While we recognize that *American Bank & Trust* and its predecessors involved property rather than income taxes, the Supreme Court stated that section 742 now applies to *all* taxes except those expressly exempted by it. (463 U.S. 855, 867, 103 S.Ct. 3369, 3377, 77 L.Ed.2d 1072, 1082.) In addition, we are unable to discern any conceptual distinction between the "formalistic theory" distinguishing a shareholder's property interest from the entity's assets (463 U.S. 855, 872-73 n. 14, 103 S.Ct. 3369, 3379-80 n. 14, 77 L.Ed.2d 1072, 1085 n. 14) and the department's theory that a shareholder's dividend income is distinguishable from the entity's income where, as here, the Trust's *entire* net income is paid regularly to its shareholders. It seems clear that the 1959 amendment to section 742 must also have abolished the relevance of the department's theory as it applies to tax-exempt dividends issued by the Trust. We find it unnecessary to consider whether the

American Bank and Trust decision eliminates the distinction between an entity and its shareholders where the entity does not regularly pay out its entire net income in dividends.

The parties have argued at length over whether the Illinois or Massachusetts categorization of the nature of the Trust should control this case. The Department contends that since the Trust has characteristics similar to those of a corporation, Illinois may tax it as if it were a corporation, through which deductions cannot pass. We note, however, that where the issue is whether, or to what extent, a Federal right or immunity applies, a State Department of Revenue's categorization of its own tax is not controlling. (See *First Aricultural National Bank v. State Tax Commission* (1968), 392 U.S. 339, 347, 88 S.Ct. 2173, 2177, 20 L.Ed.2d 1138, 1144; *Society for Savings v. Bowers* (1955), 349 U.S. 143, 151, 75 S.Ct. 607, 611-12, 99 L.Ed. 950, 959.) As discussed above, section 742 is the codification of an immunity from taxation mandated by the United States Constitution. (See, *e.g.*, *Memphis Bank & Trust Co. v. Garner* (1983), 459 U.S. 392, 397, 103 S.Ct. 692, 695-96, 75 L.Ed.2d 562, 567.) We therefore conclude that it is irrelevant whether or not the Department appropriately categorized the Trust as a corporation, and hold that Illinois may not include in the taxpayers' gross income the dividend income received from the Trust which is attributable to its holdings in U.S. Government Securities.

II.

Plaintiffs next argue that the Department incorrectly classified the Trust's repurchase agreements as secured loans rather than sales. The transactions are arranged as follows. The Trust agrees to purchase certain U.S. Government securities from a bank or other seller and simultaneously agrees to resell the same securities to the same party on a certain, fixed date, which is generally within a few days of the original sale date. The seller agrees

to pay the Trust interest at a fixed rate for the period between the original sale and the repurchase. The record contains some representative repurchase agreements supplied by the Trust. Some of the agreements refer to the original purchase price as "principal" and to the government securities as "collateral".

Plaintiffs argue that the broad language of section 742 implies that it is irrelevant whether or not the transactions are sales or secured loans, because any tax on the interest received on them would necessarily require the State to consider income from government securities which is prohibited by section 742. (31 U.S.C. sec. 742 (1976).) We disagree.

In reviewing similar transactions involving municipal bonds, Federal courts have consistently held that the Federal income tax exemption provided for income received from State or municipal obligations (26 U.S.C. sec. 103(a) (1954)) is available only to the taxpayer who actually owns the securities—*i.e.*, the taxpayer who has the right to dispose of them and who bears the risk of a profit or loss. (See *American National Bank v. United States* (5th Cir. 1970), 421 F.2d 442, 451, and cases cited therein.) Plaintiffs have cited no authority holding that section 742 requires immunizing from State taxation the income of anyone other than the owner of Federal government securities, nor have we found any authority supporting plaintiffs' position.

While we recognize that section 742 is a constitutionally mandated immunization from taxation (see, *e.g.*, *Memphis Bank & Trust Co. v. Garner* (1983), 459 U.S. 392, 397, 103 S.Ct. 692, 695-96, 74 L.Ed.2d 562, 567) rather than a legislative exemption from a particular tax, the scope of the immunity it affords is not unlimited. In *First National Bank v. Bartow County Board of Tax Assessors* ((1985), 470 U.S. 583, 105 S.Ct. 1516, 84 L.Ed.2d 535) the Supreme Court held that section 742 did not require a State to permit a bank to deduct the full value of its government securities from its gross assets. The court recognized that, because the bank may have incurred lia-

bilities, the interest on which was also deductible, to acquire the securities, the statute was satisfied by the State's allowing only a pro-rata deduction from the bank's net worth for the securities. The court concluded that the bank should not be allowed to use Federal obligations to shelter otherwise taxable assets. (470 U.S. 583, 594-97, 105 S.Ct. 1516, 1523-24, 84 L.Ed.2d 535, 545.) If the Trust is not the true owner of these securities, but is merely loaning the sellers the securities' purchase price and thereby earning otherwise taxable interest income, we conclude that it may not shelter that income from State taxation by allowing the borrowers to secure the loans with tax-exempt Federal securities.

In determining whether or not a repurchase transaction is actually a loan, Federal courts consider the entire transaction, and look to the following, specific factors, which, if present, tend to indicate that the transaction is a loan: (1) whether the seller could require the purchaser to resell the securities; (2) whether the purchaser could require the seller to repurchase them; (3) whether the agreement provides either party a specific remedy in the event that the other defaults; (4) whether the seller agreed to pay interest at a stipulated rate between the sale and resale; and (5) whether the amount advanced does not necessarily equal the fair market value of the securities sold. (See *Citizens National Bank v. United States* (1977), 551 F. 2d 832, 842, 213 Ct.Cl. 236.) Other indications of a loan are: (6) whether the identical securities are bought and sold, and (7) whether the purchaser may sell the securities for the seller's account in the event of a default. See I.R.S. Rev.Rul. 74-27 (1974-1 C.B. 24). See also, I.R.S.Rev.Rul. 82-144 (1982-2 C.B. 34) transaction held to be purchase where the purchaser could sell the securities at will); I.R.S. Rev.Rul. 77-59 (1977-1 C.B. 196) (transaction was found to be loan only and the purchaser's assets were found not to be the securities themselves, but the seller's obligation to repay the funds loaned).

Here, the Trust and the sellers affirmatively agreed to a repurchase transaction involving the same securities at

the time of the sale, and either could therefore properly require the other to perform. And while the agreements do not expressly provide mutual remedies in the event of a default, plaintiffs have stated that the Trust is authorized to sell the securities if the seller defaults. There is no indication that a default sale would relieve the seller of the obligation to pay the agreed amount, and we therefore perceive that such a default sale would only act as a credit against any amount still owed by the seller under the original agreement. In adition, all of the sample agreements clearly set a specific rate of interest.

The Department has not argued that the sale amounts do not accurately reflect the value of the securities, and we will therefore assume that they do. The evidence nevertheless clearly indicates that the Trust accepted none of the risks of ownership, and we therefore conclude that the transactions were secured loans rather than sales. See *American National Bank v. United States* (5th Cir., 1970), 421 F.2d 442, 451.

Plaintiffs argue that public policy considerations require that the interest derived from these transactions be considered tax-exempt because they impact so greatly on the Federal security market, and denying the exemption would adversely affect the attractiveness of Federal securities to investors. We note, however, that the Supreme Court rejected that argument in *First National Bank v. Bartow County Board of Tax Assessors* ((1985), 470 U.S. 583, 105 S.Ct. 1516, 84 L.Ed.2d 535), where, as here, the taxpayers were unable to demonstrate that the impact would be so great as to cause investors to ignore the other advantages of Federal securities, such as their great liquidity and safety. (470 U.S. 583, 596-97, 105 S.Ct. 1516, 1524, 84 L.Ed.2d 535, 546.) The court concluded that "[t]he tax exemption required by the Constitution and [section 742] is not a tax shelter." (470 U.S. 583, 597, 105 S.Ct. 1516, 1524, 84 L.Ed.2d 535, 546.) We therefore affirm the circuit court's conclusion that income derived by the Trust from these repurchase agreements is not tax-exempt.

The decision of the circuit court is reversed in part, affirmed in part and remanded with directions to permit taxpayers to deduct from their gross income that proportion of the dividends they received from the Trust that is attributable to income from U.S. Government securities, but not the amount attributable to income from repurchase agreements.

Reversed in part, affirmed in part, and remanded.

INGLIS and REINHARD, JJ., concur.

(Letterhead Of)

ILLINOIS SUPREME COURT
Juleann Hornyak, Clerk
Supreme Court Building
Springfield, Ill. 62706
(217) 782-2035

October 7, 1987

Mr. Bret Rappaport
Asst. Attorney General
100 W. Randolph St., 12th Flr.
Chicago, IL 60601

No. 65211—Stephen J. Andras, et al., respondents, v. Illinois Department of Revenue, et al., etc., petitioners. Leave to appeal, Appellate Court, Second District.

The Supreme Court today *DENIED* the petition for leave to appeal in the above entitled cause.

The mandate of this Court will issue to the Appellate Court on October 29, 1987.

CIRCUIT COURT FOR THE
16TH JUDICIAL CIRCUIT
KANE COUNTY, ILLINOIS

GEN. NO. TX KA 85-0381

Stephen J. Andras et al

Plaintiff(s)

vs.

Illinois Department of Revenue

Defendant(s)

Judge Marvin Dunn

JUDGMENT ORDER

This matter coming before the Court on an action for Administrative Review, this Court having reviewed the written briefs and oral argument of counsel, and being fully advised in the premises,

IT IS ORDERED: for reasons stated of record:

1) The decision of the Illinois Department of Revenue is Affirmed.

2) This is a final and appealable Judgment.

Entered: May 22, 1986

/s/ Marvin Dunn
Judge

ILLINOIS DEPARTMENT OF REVENUE
Income Tax Legal Division
State of Illinois Center
100 West Randolph, Suite 7-600
Chicago, Illinois 60615

NOTICE OF DECISION

Illinois Department
of Revenue

v.

Stephen J. Andras
Betty I. Andras
SSN: 187-16-0770

Tax Year Ended	Claim for Refund
12/31/80	$ 338.00

/s/ J. Thomas Johnson
Director of Revenue

September 11, 1985

Hearing Officers: Shepard K. Smith
Edward B. Pappert

Hearing Held: 11/10/83

Taxpayer's Representative: David W. Oakes
Drendel, Schanlaber,
Horwitz & Oakes
520 Redwood Drive
Aurora, IL 60506

TAXPAYERS: Stephen J. & Betty I. Andras
SSN: 187-16-0770

I. *JURISDICTION*

Claim for Refund	Year Ending	12/31/80
Statute of Limitations		04/15/84
Date Claim Filed		10/26/81
Date Claim Deemed Denied		04/26/82
Date Protest Due		06/10/82
Date Protest Filed		05/07/82

II. *ISSUES*

1. Whether the amounts received by the taxpayers as distributions from a regulated investment company (mutual fund) are exempt from taxation by the State of Illinois where the mutual fund has invested in U.S. Government securities.
2. Whether interest received by the mutual fund as a result of repurchase agreement transactions (the subject matter of which is tax-exempt U.S. Government securities) is equivalent to interest received from direct investments in similar U.S. Government securities.

III. *FINDINGS OF FACT*

The Hearing Officer having reviewed the entire record makes the following findings of fact:

1. The taxpayers, Stephen J. and Betty I. Andras were residents of the State of Illinois for the taxable year ending 12/31/80.
2. The taxpayers timely filed an Illinois Income Tax return, Form IL-1040 for the year ending 12/31/80, indicating a subtraction modification on Line 4a thereof in the amount of $13,552.00, Line 4a being, "Interest on U.S. Treasury obligations included in amount on line 1."

3. The Illinois Department of Revenue issued a notice of change to the taxpayers, Form ITR-76-2 which indicated that, "Your entry on line 4a has been reduced to zero because it does not appear to be interest from U.S. Government obligations." An additional $338.00 in tax plus interest of $9.22 was shown to be due.

4. The taxpayers paid the additional amount due and timely filed an Amended Illinois Income Tax Return, Form IL-1040-X, for the taxable year ending 12/31/80 showing a claim for refund in the amount of $338.00. This amended return was received by the Department of Revenue 10/26/81.

5. On 4/26/82, the claim for refund as shown on taxpayer's amended return was deemed denied pursuant to Section 909(e), Illinois Income Tax Act.

6. On 5/7/82, the Department of Revenue received a timely filed protest to the denial of the claim for refund.

7. On 11/10/83, a hearing was held at the Department of Revenue, 160 N. LaSalle Street, Chicago, Illinois for the purpose of receiving evidence for a reconsideration of the taxpayers' claim for refund.

8. The subtraction modification in question was a distribution from the Trust for Short-Term U.S. Government Securities.

9. The Trust for Short-Term U.S. Government securities is considered a regulated investment company (commonly known as a mutual fund) subject to the provisions of Sections 851-855 of the United States Internal Revenue Code (among others). The financial structure, purposes, investments and nature of income are described in the prospectus which is admitted into the record as T.P. Exhibit 1-4.

IV. *DISCUSSION OF FACTS & LAW*

ISSUE I.

Whether amounts received by the taxpayers as distributions from a regulated investment company (mutual fund) are exempt from taxation by the State of Illinois where the mutual fund has invested in U.S. Government securities.

Pursuant to Section 203, Illinois Income Tax Act, the taxpayers base income is an amount equal to the taxpayers' federal adjusted gross income for the taxable year as modified by certain additions and subtractions specified in Section 203(a)(2). In this instance, the taxpayers' federal adjusted gross income included $13,552.00 as dividends paid by "FEDERATED US GOVT FD." This amount was, in fact, a distribution from the Trust for Short-Term U.S. Government Securities (T.P. Exhibit No. 4-1). The taxpayers now seek to have this amount removed from their Illinois base income. They claim that a subtraction modification was available to them under Section 203(a)(2)(I) which provided for a subtraction of:

> "An amount equal to all amounts included in such total which are exempt from taxation by this State either by reason of its Constitution or by reason of the Constitution, treatises or statutes of the United States." (currently Section 203(a)(2)(Q) amended through P.A. 83-1540 (1/14/85)).

The words "such total" refer to the sum of the taxpayers' adjusted gross income plus addition modifications under Section 203.

The specific federal statute upon which the taxpayers rely is 31 U.S.C. §742 (recodified as 31 U.S.C. §3124) which provides that:

> "All stocks, bonds, Treasury notes, and other obligations of the United States, shall be exempt from taxation by or under State or municipal or local authority. This exemption extends to every form of taxation that would require that either the obligations or

> the interest thereon, or both, be considered directly or indirectly in the computation of the tax, except nondiscriminatory franchise or other nonproperty taxes in lieu thereof imposed on corporations and except estate taxes or inheritance taxes."

The taxpayers then argue that there should be a "pass-through" to the shareholders of the trust (mutual fund) of the tax-exempt "character" of the interest income received by the trust which then qualifies as a subtraction modification for the individual taxpayers-shareholders.

The question thus becomes one of determining what the taxpayers received in this case. As a general rule, a Massachusetts Trust is classified for purposes of taxation as a corporation and not as a trust or a partnership. The term corporation includes associations. (Internal Revenue Code of 1954, Section 7701(a)(3) and Illinois Income Tax Act Section 1501(a)(4)). The term association refers to an organization whose characteristics require it to be classified for purposes of taxation as a corporation rather than as another type of organization such as a partnership or a trust. (IRC Reg. 301.7701-2(a)(1)). Further, "association" has been held to include "Massachusetts Trusts carrying on a business enterprise through a quasi corporate organization." *Hecht v. Malley*, 265 U.S. 144 (1924). And, IRC Reg. 301.7701-4(c) indicates that an investment trust of the type commonly known as a management trust is an "association."

A corporation is generally a nonconductor with respect to the dividends paid to its shareholders and the corporate funds from which the dividends are declared. (*Miller v. City of Milwaukee*, 272 U.S. 713 (1927). There is no "character" to the dividends paid to shareholders relative to the funds from which the dividends are derived. Income which may be tax-exempt to a corporation does not flow through as a tax-exempt distribution to the shareholders. See IRC Reg. §1.312-6(b) for example, which provides, "Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is

taxable to the same extent as other dividends when distributed to shareholders in the form of dividends."

Unless there is a specifically authorized "pass-through" treatment accorded to a certain type of income, the distinction and separation between taxable entities and the individual owners thereof is well-settled. *National Carbide Corp. v. C.I.R.*, 336 U.S. 422 (1949); *Van Allen v. The Assessors*, 70 U.S. 229 (1866). And, the application of such a distinction and separation resulting in the disallowance of flow-through of tax-exempt status has been applied in for example, *Bess Schoellkopf*, 32 B.T.A. 88 (1935), *appeal dismissed*, August 25, 1936. In that case, the court required the holders of certificates of indebtedness of a trust to include in their gross incomes the interest paid to them even though the certificates were backed by otherwise federal tax free state and local obligations.

The taxpayers make the further argument that Section 852 of the Internal Revenue Code "characterizes" the federal obligation interest as such in the hands of distributees of a mutual fund/regulated investment company. Although they admit that the Internal Revenue Code does not specifically say so (T.P. Exhibit No. 1-1), they claim that it is implied therein. And, since under Section 1-102 of the Illinois Income Tax Act for Illinois purposes, terms "have the same meaning as when used in a comparable context in the United States Internal Revenue Code of 1954. . . .", this federal "characterization" must be applied for Illinois Income Tax purposes. This argument fails for at least two reasons.

First, the Illinois Income Tax Act clearly states any "term" used shall have the same meaning as "when used in a comparable context in the United States Internal Revenue Code of 1954. . . ." There are no terms such as "federal interest", "federal tax-exempt interest", "U.S. Government obligations", used in either Internal Revenue Code Section 852 or Section 203 of the Illinois Income Tax Act.

Second, Section 852 of the Internal Revenue Code does not imply a federal interest "characterization" despite what the taxpayers may infer. Where the Internal Revenue Code intends to characterize a certain type of income for a certain purpose, it does so in clear language. For example, with respect to partnerships and partners, Internal Revenue Code Section 702(b) provides that the character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share "shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership." The term "distributive share" is found in the Illinois Income Tax Act at Section 502(d) and elsewhere. Further, with respect to trusts and beneficiaries, Internal Revenue Code Sections 662(a) and 662(b) provide that amounts "paid, credited or required to be distributed," shall have the same character in the hands of the beneficiary as in the hands of the estate or trust. The term "paid, credited or required to be distributed" is found in Section 203(c)(3) of the Illinois Income Tax Act and elsewhere. There is no such blanket federal tax provision establishing the "character" of the income flowing through a regulated investment company to the shareholders. Instead, there are limited "character" flow-through provisions with respect to exempt interest dividends and capital gains under prescribed conditions.

The dividends received by shareholders of a regulated investment company are treated no differently under the Illinois Income Tax Act than are dividends received from any other corporation. There is no exemption due to the source of the funds used to pay the dividends as there is no exemption for dividends paid by other corporations which also may have invested in U.S. Government obligations.

The taxpayers' argument that Illinois is prevented from taxing these distributions as a result of the Supreme Court decision in *American Bank and Trust Co. v. Dallas County*, 463 U.S. 855 (1983) is also rejected. The Court

therein indicated the test under 31 U.S.C. §742 to be whether "federal obligations must be considered, either directly or indirectly, in computing the tax."

First, the Illinois Income Tax is not imposed on federal obligations or the interest thereon. The tax is however, imposed on all corporate dividend distributions received by an Illinois taxpayer, regardless of the derivation or source of the funds used by the corporation to pay the dividends. There is no "character" as to dividends received for Illinois Income Tax purposes.

Second, there are no federal obligations or interest thereon being considered, even indirectly, in the computation of the Illinois Income Tax in this case. In the *American Bank* case, the state bank shares tax was calculated by determining the amount of the capital assets of the bank, including federal obligations in the total. There was no direct tax on the obligations, however, they were indirectly taxed having actually been included in the net asset value. This is distinguishable from the Illinois Income Tax Act which is neither taxing federal obligations nor interest thereon either directly or indirectly, but is taxing dividends which may happen to be derived from federal obligations.

ISSUE II:

Whether interest received by the mutual fund as a result of repurchase agreement transactions (the subject matter of which is tax-exempt U.S. Government securities) is equivalent to interest received from direct investments in similar U.S. Government securities.

It has been held that only "persons having the rights and incurring the risks that ownership of municipal bonds entails may treat the interest realized by them on the municipals they own as tax-exempt income. . . ." *American National Bank of Austin v. U.S.*, 421 F.2d 442, 451 (5th Cir. 1970). In the instant case, the mutual fund "purchased" U.S. Government securities subject to "repurchase agreements" evidenced by confirmations of the "sales." The

question is thus whether or not the mutual fund was actually the owner of the securities which would allow it to treat the interest received therefrom as exempt.

Revenue Ruling 77-59 (1977-1 C.B. 196) is concerned with just such agreements:

> "The trust, desiring to invest money for a specified period of time (generally overnight or for not more than several days) at a specified rate of interest, "purchases" from a bank a stated face amount of United States Treasury obligations (or, upon occasion, negotiable certificates of deposit, banker's acceptances, or commercial paper) of a specific description. Simultaneously, the trust agrees to "resell" the obligations to the bank on a fixed date at the "purchase price" plus an agreed amount of interest, the current rate for such obligations.
>
> The transactions are typically evidenced by a confirmation ticket or a set of simultaneously issues confirmation tickets (one confirming the bank's "sale" and the other confirming the bank's "repurchase"). Although the transaction is termed a "sale" and "repurchase" and the confirmation tickets are generally termed "repurchase agreement," possession of the obligations that are the subject of the "repurchase agreement" is not normally transferred to the trust and no formal written agreement of sale and repurchase is executed. No specific security is credited to the trust's account on the bank's books and the United States Treasury obligations are not marked in any manner to indicate that they are owned by anyone other than the bank. The trust neither benefits nor suffers from any change in either the market value of the United States Treasury obligations or the rate of interest paid in respect of loans secured by such obligations. The trust receives interest at the rate specified in the confirmation tickets."

The ruling goes on to hold, "Accordingly, the repurchase agreement transactions entered into by the trust are loans to the bank secured by the United States Treasury obliga-

tions (or other forms of collateral)." The evidence in the instant case (T.P. Exhibit No. 9) consisting of confirmation of repurchase agreements appears to be exactly as described in the revenue ruling. In fact, some of the documents even contain the statement, "We reserve the right to substitute like collateral." (T.P. Exhibit No. 9, Citicorp documents). This further reinforces the determination that the transactions are in substance secured loans. As stated in *American National Bank of Austin v. U.S.*, (supra), "To us the (purchaser) was simply a lender of its funds to the dealers. For this service it was paid interest by the borrowing dealers. Taxpayer took only the risks of a lender in these transactions. We must, therefore, look beyond the forms and terms which the (purchaser) and the dealers attributed to these dealings to the real substance thereof."

Interestingly, the prospectus for the Trust (T.P. Exhibit No. 1-4, page 6) states:

> "INVESTMENT LIMITATIONS—The Trust operates under certain restrictions which may not be changed without shareholder approval. The trust may not . . . . (4) lend any assets of the Trust (except that it may purchase or hold U.S. Government securities including repurchase agreements as permitted by its investment objective and policies); . . . ."

Apparently the trust itself recognizes the lending nature of such agreements.

Similar "repurchase agreements" were held to be loan transactions in *Third National Bank in Nashville v. U.S.*, 71-1 USTC 85, 985 (1970) and *First National Bank of Nashville v. U.S.*, 467 F.2d 1098 (6th Cir. 1972). Also see Rev. Rul. 74-27, 1974-1 C.B. 24, holding that a bank ("purchaser") receiving interest on tax-exempt securities held by it under so-called "purchase and resale" agreements entered into with customers is not entitled to exclude such interest from its gross income under Section 103 of the Internal Revenue Code but such tax-exempt interest is income of the customers and the bank must report the interest charged such customers as income under Section 61 of the Code.

Further, Rev. Rul. 82-144 (1982-2 C.B. 34) indicates that no absolute rule can be established to determine which party to a transaction will be considered the owner of the property. The party that bears the economic burdens and benefits will be considered the owner. To make the determination of ownership, two significant factors are: (1) which party has the right to dispose of the property, and (2) which party bears the risk of profit or loss with respect to the property. In this case, all of the repurchase agreements in the file indicate a "return date", "due date", "maturity date", or "repayment date". The Trust as the purported purchaser was always under an obligation to "resell" the securities to the banks and the banks were under obligation to "repurchase." There is no other evidence which would indicate that the Trust could dispose of the subject matter securities as their own property.

In addition, the Trust was not entitled to the benefit of any appreciation in the value of the securities and was shielded from the risk of loss. The "repurchase" price in each instance, set at the time of the "sale" was always the same as the price initially "paid". The amounts were the same without regard to the length of time "held" by the Trust, the stated interest rate or market conditions.

Since the Trust apparently could not dispose of the securities and did not bear the risk of profit or loss, it cannot be considered the owner of the property for tax purposes. Accordingly, not being considered the owner of the U.S. Government securities, that interest received by the Trust is ordinary interest paid by the banks as a result of lending transactions and is not exempt interest from the securities.

V. *CONCLUSIONS*

Interest received as a result of engaging in repurchase agreement transactions is ordinary interest income to the recipient, notwithstanding the fact that the underlying subject matter of the transactions is U.S. Government securities. Such income would not qualify for a subtraction modification under any subsection of Section 203(a)(2)

of the Illinois Income Tax Act. The weekly portfolio of the Trust for Short-Term U.S. Government securities indicated that the fund had an investment in repurchase agreement transactions of between 3% and 27% at any given time during the year ending 12/31/80. Thus, at no time during the year ending 12/31/80 would the income of the fund even have qualified for a subtraction modification assuming it could be considered to "flow-through" to the shareholders.

Further, there is no authority for the position that the income of the mutual fund for purposes of Illinois income tax on the distributions by the fund to its shareholders "flows-through" or is "characterized" in the recipients hands as it is "characterized" to the fund in the first place. There is, in fact, a distinction and separation with respect to the distributions to the shareholders, such distributions being dividends from a corporation under the Illinois Income Tax Act. The prospectus for the fund itself (T.P. Exhibit No. 1-4, p. 15) recognizes this result, stating "Under state law, distributions of net investment income may be taxable to shareholders as dividend income even though such distributions may be derived from interest on U.S. Government obligations which, if received directly, would be exempt from state income taxes."

As a consequence of the previous analysis, the taxpayers in this instance, having received a dividend distribution from a mutual fund, are not entitled to a subtraction modification with respect to the amount of that distribution under any of the provisions of the Illinois Income Tax Act.

IV. *DECISION*

It is the decision of the Director of Revenue that the taxpayers' claim for refund in the amount of $338.00 for the taxable year ending 12/31/80 is denied in full.

/s/ Edward B. Pappert
Hearing Officer

EBP:gw